

Trends in the Private Equity Secondary Market

A Response to Today's Financial Markets

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The *New York Times* reported that Harvard University's endowment lost 22 percent in the second half of 2008. As a result of the market turmoil and problems in the private equity market, Harvard is seeking to sell \$1.5 billion of its private equity holdings. And this is just one institution. For years the private equity market seemed invincible—values would forever increase, investors would always clamor to get a piece of a fund, and investors would never default on future commitments. But the recent upheaval in the financial markets has changed all of these assumptions. Many institutions are now seeking to liquidate interests in private equity funds in an effort to rebalance their assets and reduce their unfunded liabilities. This rush to liquidate is creating a massive supply in interests and is likely to result in a robust secondary market for private equity interests.

Why Does a Secondary Market Exist?

Typically, investors in private equity funds acquire their interests directly from a fund, in a "primary"

transaction. In a private equity "secondary" transaction, an existing investor in a fund seeks to sell the interest to a buyer, thereby creating a secondary market for that interest. Over the past several years, this market has grown tremendously and, for reasons discussed below, is expected to continue to grow at an accelerated pace in the coming months as many investors look to reduce their private equity exposure.

Private equity fund investments, by their nature, are illiquid. State and federal securities laws and the fund's governing agreements impose significant restrictions on transfer. The life of a fund is typically 10 years or more, and investors do not have redemption, withdrawal, or other rights to cash out their investment. Investors are obligated to contribute capital in installments over the life of the fund, and there are significant penalties for default on these contribution obligations. Thus, an investment in a fund represents a long-term commitment. Secondary buyers, however, can, with the consent of the relevant funds, offer liquidity for investors looking to sell an individual interest in a fund, or a portfolio of fund interests.

The buyer in a secondary transaction assumes the obligations (including obligations to make capital contributions) of the seller under the fund's governing document (typically

a limited partnership agreement), provides representations and warranties to the fund similar to those that would be included in a subscription agreement for a primary purchase of an interest, and seeks to obtain the benefits of any side letter or other special arrangement between the seller and the fund, such as the right to appoint an advisory committee member.

Why Is the Market Growing?

Motivated Sellers and Buyers. In recent years, investors have had many reasons to sell, and secondary buyers have had many reasons to buy private equity fund interests, sparking growth in the secondary market. Investors have been very motivated to sell their fund interests in order to generate cash, reduce their private equity exposure, eliminate balance sheet liabilities associated with unfunded capital commitments, reallocate resources to funds of a newer vintage or with a different sector focus, and limit the number of fund manager relationships and the associated administrative costs. Secondary buyers are increasingly able to take advantage of sellers' limited liquidity options by purchasing these interests at a significant discount to net asset value. In addition, buyers in secondary transactions have access to more information on a fund's existing portfolio company investments

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and return history because buyers are not investing in a fund at its inception. The attractive purchase price and access to greater information make secondary purchases attractive, as demonstrated by the billions of dollars in capital raised in recent years by fund-of-funds focused on making secondary purchases.

Drivers of Market Growth. As a result of the recent market turmoil, it is anticipated that private equity secondary transactions will increase dramatically. Many investors have a heightened need for cash and a desire to decrease unfunded capital commitment liabilities on their balance sheets. Financial institutions, endowments, and pension plans in particular may have high-quality portfolios of private equity interests that they want to sell.

Historically, as distributions from existing private equity investments declined, there has been a corresponding uptick in secondary transaction activity. Due to low valuations and reduced merger and acquisition activity, it is expected that distributions from private equity funds will experience a sharp decline in the near term. As a result, investors may find that selling interests in some funds to provide cash for upcoming capital calls in other funds is the only viable option to avoid defaulting on commitments.

Buyers of private equity interests are highly motivated by the opportunity to purchase fund interests at historically low valuations. As discussed below, the purchase price paid for a private equity interest in a secondary is typically based on the fund's net asset value (NAV). Private equity funds determine their NAVs on a periodic basis (annually, semiannually, or quarterly). Markdowns in NAV resulting from the fall 2008 market downturn should be reflected on December 31, 2008, financial statements. Assuming market volatility settles by the first quarter of 2009, buyers may be excited at the prospect of purchasing fund interests at these low values. This desire to purchase may be enhanced by the fact that many secondary buyers may feel they

overpaid for interests purchased in the last two years and will seek to average down their cost basis.

Price as a Potential Obstacle. As the supply of private equity interests multiplies and sellers become more distressed, buyers are likely to become increasingly aggressive in their pricing. In addition, buyers do not want to overpay for interests that may continue to decline

Secondary buyers are increasingly able to purchase interests at a significant discount.

in value. This may create a significant disconnect between the price at which a seller is willing to sell and the price at which a buyer is willing to buy. Unless the market stabilizes so that both buyers and sellers can have visibility as to the future value of the interests (not just the NAV as of a prior time period), there is a risk that buyers and sellers will be unable to agree on price and get a deal done. It is possible that this disconnect will be so extreme that sellers will not be able to "give away" certain funds, meaning that for certain undesirable funds no buyer will assume the liability of the unfunded capital commitment—even if no purchase price is paid for the interest.

What Are Key Negotiating Points?

There are three key sets of negotiations during a secondary transaction:

- initial purchase price for the portfolio of interests being sold;
- purchase and sale agreement between the buyer and seller; and
- transfer documentation among the buyer, seller, and fund managers of the interests being sold.

Purchase Price. The purchase price in a secondary transaction is usually based on the value of the interests being sold as of a set date, which is referred to as the cut-off date. The cut-off date is tied to the date of the most recent NAV calculations and the

purchase price is driven by the NAV (it is either at par or at a discount or premium to NAV, depending on the buyer's valuation). At the closing of each transfer, the purchase price has a dollar-for-dollar adjustment for capital contributions made by the seller (increase in purchase price) and distributions received by the seller (decrease in purchase price) since the cutoff date. Historically, prices have trended close to par with only a moderate discount or premium. Transaction pricing before December 31, 2008, financials are available have been at a significant discount (averaging around 40 percent and going up to 50 percent or more) off of NAV. Low December 31, 2008, NAVs present a favorable starting point for buyers to negotiate price.

A buyer and seller frequently sign a letter of intent to memorialize the agreed-upon purchase price. It should be noted that although the economics are set as of the cutoff date, timing considerations are important. For example, a buyer will typically prefer to receive a distribution shortly after closing rather than getting a purchase price reduction so that the buyer can record the distribution as a gain on investment and include it in its internal rate of return computations.

Purchase and Sale Agreement. The definitive agreement for a secondary transaction is typically a purchase and sale agreement and resembles an asset purchase agreement used in a standard asset acquisition. The following are the key negotiated terms in secondary transaction purchase and sale agreements:

- LP clawback coverage—It is common practice for a seller to indemnify a buyer for any obligation (referred to as a clawback) to return to a fund distributions that were made prior to the cutoff date. The seller and buyer also may include a mechanism to calculate the liability for a clawback of funds that are not attributable to a particular distribution. Frequently this liability will be shared pro rata based on the amount of distributions each of the buyer and seller received from the

fund. The caps on such clawback obligations are often heavily negotiated.

- **Threshold funds**—In connection with a sale of a portfolio of fund interests, threshold funds are sometimes identified by the buyer. These are funds that the buyer will require to be transferred to it before the buyer will be required to close on any other funds in the portfolio. This focuses the attention in the transfer process on funds identified by the buyer as essential and provides a buyer with comfort that it will not be forced to buy only the less-attractive interests in a portfolio. It is possible that sellers will soon seek to avail themselves of similar provisions, focusing on funds that are essential to be included in a portfolio sale. In

This will likely lead to a boom year for secondary transactions.

particular, as sellers become more distressed, they may structure transactions so that when a buyer buys a fund managed by a top-tier manager, the buyer also must purchase a less-desirable fund.

- **MAC clauses**—It has become increasingly common for purchase and sale agreements to include as a closing condition that no material adverse change (MAC) has occurred between signing and closing. These clauses have ranged from very broad coverage to more tailored provisions focusing on the departure of a particular manager. It is expected that MAC clauses will be more common and more heavily negotiated in the next wave of transactions. Until recently, there had been no public reports that a buyer had invoked this clause and refused to close. In October 2008, it was reported that HarbourVest Partners backed out of a signed agreement to acquire private equity interests in reliance on a MAC condition. To date, the seller has not chosen to challenge the buyer's position, due to

time constraints, so it is unlikely that this particular MAC clause will be interpreted by a court. Nonetheless, the buyer's ability to walk away from the transaction due to an alleged MAC provides another example of the recent increased negotiating power of buyers in secondary transactions.

- **Staple funds**—Another popular feature in secondary transactions has been the requirement by a fund manager that a secondary buyer commit to invest in a new fund sponsored by the same fund manager in order to obtain the fund manager's consent to the transfer of the interest in the existing fund. Buyers resist this provision because they do not want to be forced into making a primary investment. Of particular concern is that the decision makers for a secondary purchase are frequently different from the decision makers for a primary purchase and buyers prefer not to conflate the two. In the first half of 2008, indications were that staple transactions would become more common. However, as the supply of secondary transactions grows, buyers will have more leverage to avoid committing to new funds because fund managers will want to accommodate transfers to reputable buyers, especially if there is a risk of default by the seller.

Transfer Process. Unlike the purchase and sale agreement, the transfer process involves the fund manager, in addition to the buyer and the seller. The buyer needs to consider issues associated with its investment in the underlying fund, and the fund needs to determine if admission of the buyer will trigger regulatory or other issues for the fund itself.

In nearly all cases, the fund manager has the right to consent to a transfer of a seller's interest. In some cases, consent cannot be unreasonably withheld, but in others the determination is made in the fund manager's sole discretion. In addition, each fund may have other transfer restrictions that can slow down the process, including compliance with right of first refusal provisions, requirements that legal opinions be delivered,

and limitations on when interests can be transferred (such as a month-end or quarter-end) for accounting and administrative purposes. Accordingly, the transfer process for each interest can be time-consuming—three months or longer.

The fund also needs to be certain that the transfer will not invalidate the fund's exemptions from registration as an investment company under the Investment Company Act of 1940. For example, a buyer and seller may be required to reduce the amount of the interest transferred in order to ensure that a fund relying on the "100 or fewer" owner exception under the Investment Company Act will not lose its exemption.

Other legal considerations of concern to the buyer include limitations on the fund's ability to generate certain types of income (such as unrelated business taxable income and effectively connected income), the fund's obligations to satisfy certain exemptions under the Employee Retirement Income Security Act (including whether the fund will qualify as a venture capital operating company), and the buyer's obligations to satisfy applicable anti-money laundering regulations.

Recently, fund managers have been expanding the indemnification coverage they expect in connection with transfers. Provisions include broad-based joint and several liability for breaches of representations and warranties and covenants in transfer agreements. Both buyers and sellers oppose these indemnification requirements. Because sellers want to remove all of the liability associated with a transferred interest from their books, they are frequently more vehemently opposed to these requirements. As funds become more wary of the solvency of both buyers and sellers, they may require additional representations and covenants by the buyer that it has (or has access to) the cash required for the entire unfunded capital commitment as well as requiring the seller to serve as a backstop in the event the buyer defaults.

As a practical matter, buyers and sellers have limited ability to negotiate the provisions of a transfer agreement because ultimately the fund manager must consent to the transfer. However, other substantive issues frequently arise during the transfer process, including requests by sellers of releases for all post-closing liabilities, requests by buyers that all pre-closing liabilities be excluded from the obligations they are assuming, and allocation between buyer and seller of the expenses of the fund's outside counsel (and whether payment is required

to be made prior to closing). Because these issues must be resolved to the satisfaction of the buyer, the seller, and the fund, they can result in somewhat protracted discussions, which lengthen the transfer process.

Conclusion

Throughout 2009, many financial institutions, endowments, pension funds, and others will need to rebalance their assets, reduce their unfunded liabilities, and generate cash. As a result, they may look to sell significant portions of their private equity

portfolios. This will likely lead to a boom year for secondary transactions as savvy buyers seek to benefit from low valuations and highly motivated and distressed sellers. As the marketplace grows and becomes more competitive, the legal and business landscape is also likely to change. New deal structures may be introduced and novel issues will inevitably arise. It is important for both buyers and sellers to be prepared for this changing, but exciting, landscape.